BEHIND THE NUMBERS
Quality of Earnings Analysis

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Patterson Companies, Inc. (PDCO) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of PDCO of 3- (Minor Concern)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

PDCO beat estimates by 7-cents in 3Q21. We see that it picked up 2.3-cents from a lower tax rate, 1.6-cents from higher investment income, lower travel expenses added 2.3-cents, lower stock compensation helped by 0.7-cents, lower depreciation 0.9-cents, and rounding up 2021 and down 2020 results helped by 0.7-cents. There's 8.5-cents worth of oddities that may not be sustainable. We still believe the travel expenses will rise going forward.

Total y/y EPS growth was 11-cents. PDCO also had $95 million in higher sales. The company is touting a 30bp gain in operating margin as well. The lower depreciation, stock compensation, and travel expenses were 31bp of the margin gain.

Working capital looks to be in better shape, but it may actually be too low now. That could help margins going forward, but may require more cash investment. Cash flow could come under pressure from rising capital spending and DPP receivables.

What is strong?

- PDCO's sales were poor earlier in this year and they were not hitting volume targets with suppliers. In 3Q, management noted that the stronger sales enabled more rebates to come through which helps margins and income levels.

- Working capital for Inventory and Receivables looks low. That produced cash flow in 3Q and could help margins in the near-term if PDCO can get better terms for larger orders, spread fixed costs and transportation over more volume, and/or doesn't need to discount on sales.

Inventory DSI	4Q	3Q	2Q	1Q
fiscal 2021		62	56	64
fiscal 2020	75	69	64	71
fiscal 2019	62	70	65	73

Receivable DSOs	4Q	3Q	2Q	1Q
fiscal 2021		49	52	60
fiscal 2020	59	52	57	55
fiscal 2019	57	55	56	56

What is weak?

- **Sales growth of $95 million actually looks very poor.**

  - $41 million came from dental consumables – of that, $33 million was higher sales for COVID supplies. PDCO believes it will keep this increased sales permanently. We disagree as dentists already bought gloves and masks and were cleaning the offices and equipment pre-COVID. The incremental supplies are things like hand sanitizer for clients and additional cleaning products – which have been in short supply at retailers, online, and other channels, which likely drove some of those sales to PDCO. As the supply chain issues are further resolved, we think some of those sales vanish and others return to normal places of fulfillment like Target, Kroger, Costco, etc.

  - $69 million came from animal consumables – PDCO touted that it rolled out new products – which to us means stocking the channel and those sales do not necessarily equal consumer sell-through. This unit was further helped by a surge of new pet adoptions and thus initial vet-visits and treatments. Historically, this

area grows at 3% and it just posted an 8.5% figure. The October quarter had much of COVID issues returning to normal and PDCO only had a 3.6% growth rate in this unit after a -0.4% figure in July.

- **Adjusted operating margin gain of 30bp also looks very poor.** PDCO touted that it sold more private label products, which carry higher margins. Hitting rebate targets means higher margins too. Management also noted that higher-margin SKUs increased as a percentage of sales. But, why aren't these factors driving margins?

    - Depreciation fell by $1.1 million and added 7bp to margin
    - Stock Compensation fell by $0.9 million and added 6bp to margin
    - Operating expense fell as there was not a $2.3 million legal bill like in 3Q20. However, the remaining decline of $2.8 million was less travel expense offset by higher wages – that was 18bp.
    - That's 31bp of margin gain and we think the travel expense will bounce and the higher wages are here to stay.

- How dependant are margins on gains from selling receivables? This is still a low margin company in our view with an operating margin of only 4.6% in 3Q21, which added back amortization of acquired intangibles. PDCO has two deals set up to sell/factor receivables and it books gains/losses when the sales occur:

	3Q21	3Q20	9mths 21	9mths 20
Adj. Operating Margin	457bp	433bp	462bp	392bp
G/L on Securitization in Op Inc.	6bp	-10bp	-5bp	-12bp
G/L on sale of contracts in Sales	-10bp	77bp	0bp	53bp

On one hand, there is some positive here in that margins are higher in 2021 despite a much lower contribution from these gains. On the other hand, it is obvious that this is an area that can make or break any quarter.

What to watch

- The falling deprecation expense noted above has us concerned with the drop in capital spending and net PP&E:

	3Q21	2Q21	1Q21	4Q20	2020	2019	2018
Depreciation	$10.1	$9.7	$10.6	$11.0	$45.0	$44.4	$45.1
Capital Spending	$6.7	$8.0	$6.4	$8.9	$41.8	$60.7	$43.3
Net PP&E	$224.3	$298.5	$300.0	$303.7	$303.7	$305.8	$290.6

We did not see a reason given for the sudden drop in net PP&E other than some assets must be fully depreciated. Almost all PP&E is in the US so there's not an FX translation. PDCO did not report an asset sale on the cash flow statement or an impairment. For years, there was basically $11 million per quarter in depreciation and $11 million in CapEx. That changed in 2021, but not to the extent for net PP&E to drop $74 million in a quarter.

Let's see what happens going forward. It is possible that capital spending could become a net drain on cash flow as it may need to exceed depreciation in the future.

- **DPP – Deferred Purchase Price receivables have been helping cash flow too.** When new receivables are securitized or sold, there is a discount applied to give the bankers a cushion against non-collections that PDCO receives last. When sales are rising, the DPP grows and is a negative on cash flow. As sales fall, the reverse is true. Of late, the accounts receivable securitization has been growing and the DPP increasing which consumes cash. However, negative sales growth on equipment means fewer new contracts to sell to the bank – thus collections exceed new DPP:

	3Q21	2Q21	1Q21
DPP Out	-$179.9	-$366.0	-$139.5
DPP In	$225.6	$269.4	$139.5
Net cash Impact	$45.7	-$96.6	$0.0

Early in COVID, some customers were given payment deferrals as a result of their offices being closed. 3Q saw some of that snap back as payments were resumed. Equipment contracts have been producing cash this year – especially in 3Q as sales growth is still negative. If equipment sales rebound, there could be a negative cash flow situation as the DPP grows more quickly.

- **We have discussed in the past that rebates and incentives are a big part of PDCO's earnings. In fact, 3Q21 saw it hit some sales targets to achieve some rebates that likely played a role in margins improving along with sales.** PDCO continues to work on its own private label brands and called this out on the earnings call:

*“**Our private label business, continues to grow at a faster rate than our dental consumables overall**. And certainly, private label makes up a large portion of the infection control and prevention products. So we view that as a good tailwind, both in terms of our revenue performance as well as our margin opportunity.”*

*“And **we're also incenting our teams to drive mix improvements and seeing the benefits in some of our higher-margin equipment and private label categories,** again, both of which are growing faster than our overall companion animal top line results.”*

Selling private-label could hinder PDCO’s ability to earn rebates and incentives from suppliers. Also, PDCO has warned in its filings that consolidation among suppliers makes it tougher to earn rebates and that rebate targets could rise higher.

- There was a new lawsuit/investigation announced in the 10-Q. There are no monetary damages asked for, but it worth following:

  *“On October 27, 2020, Patterson’s Board received a written demand from Matthew Davis to undertake **an independent investigation and take action to remedy alleged breaches of fiduciary duties by the following current and former directors and officers of Patterson:** John Buck, Scott Anderson, Stephen Armstrong, Ann Gugino, Mark Walchirk, Alex Blanco, Jody Feragen, Sarena Lin, Ellen Rudnick, Neil Schrimsher, Les Vinney, James Wiltz, Paul Guggenheim, David Misiak, Harold Slavkin and Tim Rogan. **The demand arises from the allegations that Patterson (a) conspired with Henry Schein and Benco over a multi-year period to boycott GPOs and fix dental supply prices; and (b) issued a series of materially false and misleading statements in connection with such scheme.** The demand seeks the institution of an action for breach of fiduciary duty and appropriate remedial measures, including obtaining damages from all persons unjustly enriched. Effective November 20, 2020, Patterson’s Board adopted a resolution expanding the scope of the previously constituted special litigation committee to include this matter. Pursuant to the resolution, the special litigation committee has complete power and authority to investigate the demand, analyze the legal rights or remedies of Patterson, determine whether those rights or remedies should be pursued, and respond to Mr. Davis on behalf of Patterson.”*

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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